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Socialist Economies Reform

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The Labor Market and the Transition of Socialist Economies

Milan Vodopivec

One challenge of the transition of socialist economies to multiparty democracy and a market economy will be to reallocate labor while minimizing the social costs of unemployment. Vodopivec identifies the key issues of labor reform and makes policy recommendations.

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This paper — a product of the Socialist Economies Reform Unit, Country Economics Department — is part of a larger effort in PRE to investigate the labor markets in socialist economies. Copies are available free from the World Bank, 1818 H Street NW, Washington DC 20433. Please contact CECSE, room N6-045, extension 37188 (44 pages).

All socialist countries of Eastern Europe except Albania are now starting to fundamentally restructure their economic and political systems — with the clear goals of a market economy and multiparty democracy. Reform of the labor market is essential to these efforts, the reform that will set wages and employment solely in the interests of efficiency, and leave social protection to the cash benefit system.

The labor market in socialist economies was traditionally plagued with grave rigidities: most importantly, workers enjoyed practically complete job security; firms were informally pressed, and even legally obliged, to hire; part-time and fixed-term employment were legally discouraged; hiring, reassigning within the firm, and dismissing on disciplinary grounds were excessively bureaucratic; both wage bills and wage rates were administratively regulated; and workers were entitled to many fringe benefits typically not found in market economies.

These rigidities produced what Vodopivec calls the full employment syndrome — a labor market characterized by inefficient labor allocation, suppressed work incentives, and inherent wage drift tendency. At the heart of this syndrome is the lack of appropriate mechanisms to enforce the exit of firms (workers) that results in a massive employment subsidization.

A key feature of the transition will be redundant labor and, almost certainly, significant unemployment, together with labor shortages for certain skills. The challenge for these economies will be to massively reallocate labor at the least social cost.

Active labor market policies will be important — not just income support schemes but policies that improve labor mobility and increase labor absorption. These economies must improve their ability to train and retrain workers and to do such things as help small businesses, improve schooling, link universities with businesses, and help with technology transfer.

To eliminate employment subsidies, argues Vodopivec, requires imposing lasting financial discipline, including transparent (individual) property rights, an unselective and transparent fiscal system, and a multiparty political system (to provide checks and balances for the ruling party and thus contain its ability to redistribute).

Vodopivec also recommends policies for job security, incomes policy, wage differentials, nonwage labor costs, and wage taxation.

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The Labor Market and the Transition of Socialist Economies*

by
Milan Vodopivec

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* This is a background study for the World Bank's research project on the labor market in Eastern Europe. Valuable comments from Simon Commander, Alan Gelb, Timothy King, and Luis Riveros are gratefully acknowledged.

All socialist countries of Eastern Europe but Albania are now starting to fundamentally restructure their economic and political systems--with the clear goals of a market economy and multiparty democracy. Reform of the labor market is essential to these efforts. First, as a factor of production, labor has the most potential for increasing productivity (Blinder 1990). Second, adjustment of the labor market has been critical to the success of reform efforts in other countries undergoing drastic adjustment.

The challenge of the transition will be to reallocate labor while minimizing the social costs of unemployment. This paper analyzes how the labor market functions in socialist economies (SEs), identifies the key issues of labor reform, and makes policy recommendations. Section 1 describes the East European countries' economic legacy from the socialist era. Section 2 focuses on features of the SE labor market, and Section 3 on how it functions. Section 4 concludes with policy implications and identifies important research issues.

1. THE LEGACY OF SOCIALIST ECONOMIES

After World War II, the countries of Eastern Europe adopted, with minor modifications, the economic system the U.S.S.R. had developed (usually referred to as a centrally planned economy, or CPE) between the two wars. The systems' two cornerstones are state ownership of the means of production and centralized planning as the means of coordinating economic activity. The central authorities--the state planning commission and branch ministries--formulate detailed production plans and control their implementation. Such an economy relies on pressure as an economic incentive, and political and ideological criteria dominate economic considerations in the formulation of plans (Brown and Neuberger 1989). The system's basic goal is rapid growth and industrialization--the latter pursued with little regard for a country's relative resource endowments.

The system initially produced relatively rapid growth in these countries, and a seeming macroeconomic rationality (it prevented open unemployment and inflation). But as early as 1948 the most eager reformer (Yugoslavia) recognized that the traditional CPE model had serious flaws. The system's main flaws were inappropriate motivation and inefficient gathering and processing of information. It has become increasingly clear that the system cannot satisfy the diversified, changing demands for consumer goods and that its capital and labor are less productive than capital and labor in other countries at a similar stage of development. Yugoslavia's dissent marked the beginning of the search for alternative models.

Despite a common basic orientation, reform efforts in the Eastern European countries vary in scope and timing. The most orthodox countries (East Germany, Czechoslovakia, and Bulgaria) have only occasionally tinkered with elements of CPE. Poland's repeated attempts to break away from formal central planning, which began in the 1950s, failed--and the Polish economy collapsed in the early 1980s. Hungary, sometimes held up as a reform success story, abandoned central planning with one stroke in 1968, and has since widened the reform--with a setback in the mid-1970s. Yugoslavia, a pioneer in reform in Eastern Europe, established the system known as self-management, which stressed worker participation in decisionmaking. The system's self-management component is overemphasized,[1] however; the Yugoslav system does not differ much from those in other socialist countries.

Reform in the SEs has been geared toward replacing central planning with a more efficient coordinating mechanism. First, mandatory short-term central plans--representing the planners' tightest hold on the economy--were abolished, to be replaced by more subtle instruments of indirect control. Second, the market (prices) was increasingly relied on to coordinate economic activity. Third, enterprises were given autonomy in many areas, ranging from price setting to decisions about product mix and investment, and even the selection of managers--an autonomy, however, that has been continually breached by government (in a peculiar relationship between government and enterprise known as state paternalism). Fourth, to improve motivation, profit incentives replaced the multiple criteria of central planning.

The sacrosanct pillar of socialist economies--untouched until the latest wave of reform--has been social ownership of the means of production. In Marxist analysis, private property leads to the exploitation of workers by capitalist owners, so the authorities of SEs tightly restricted the private sector and condemned proposals to change the ownership structure.[2]

1/ Ward (1958) precipitated a stream of literature analogous to analysis of capitalist firms except that income per worker is maximized instead of profit. Ward aptly called his firm "Illyrian." Many of his followers take it for a Yugoslav firm even though the resemblance is as remote as the millennia since ancient Illyria. Underemployment, for example, one of the key predictions of the Illyrian analysis, contradicts the facts.

2/ As late as 1971, a reform-minded Yugoslavia ousted a Slovenian prime minister for advocating the introduction of shares.

The problems faced by the SEs

The main problems plaguing the SEs are: allocative inefficiency, X-inefficiency, dynamic inefficiency, macroeconomic instability, and distributive inefficiency.

Allocative inefficiency. Without equilibrium prices, planners do not know the true opportunity costs of factors of production so they are bound to combine them inefficiently. This, together with X-inefficiency and dynamic inefficiency, makes investments inefficient. In Yugoslavia, for example, the average efficiency in investment (in terms of generating output growth) is estimated to be only 70 percent of that of other European nonsocialist countries at a similar stage of development (Bajt 1988). Similar results probably apply for other Eastern European countries.

X-inefficiency (Leibenstein 1966).[3] Socialist firms are especially prone to this type of inefficiency. To a large extent, a firm's X-inefficiency depends on the availability and effectiveness of disciplinary devices external to the firm. These are lacking or function less efficiently under socialism than under capitalism; under capitalism, one may rely on the market for corporate control (Manne 1965), capital market (Jensen and Meckling 1976), market for managers (Fama 1980), and products market (bankruptcy) to prevent long-run lapses in firm efficiency. In socialist countries, the first two markets do not exist. Their effectiveness in capitalist countries is disputed, but their overall effect is likely to be positive. Nor, under

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3/ This concept involves the internal efficiency of firms, regardless of the economy-wide rationality of choice of inputs or technology.

socialism, can one really talk about a market for managers.[4] And products markets--the threat of bankruptcy--creates even less pressure under socialism because of the state's paternalistic attitude toward ailing firms. The environment of socialist firms is much less hostile than that of capitalist firms,[5] and their internal efficiency is accordingly lower.[6] Moreover, the lack of appropriate external pressure is accentuated by systemic constraints on the internal organization of the firm. Career advancement, for example, is often tied to such noneconomic considerations as membership in the communist party (Adam 1984, 28).

Dynamic inefficiency. Socialist firms are notorious for adapting poorly technologically and for generating few technological innovations. This is chiefly because rewards are separated from those who have generated them, because of rigidities in the social sector and constraints on the private one. The theoretical advantages of the system in terms of R&D (no wasteful duplication, the possibilities of efficiently disseminating R&D results because R&D finance is not linked to the revenues generated by it, Arrow 1962) are outweighed by the system's shortcomings.

Macroeconomic instability. The notorious job security in SEs is accomplished through massive redistribution of income (see below). But there

4/ Kornai (1986a) claims that "[t]here is no genuine 'job market' for managers; their career depends to a large extent on the opinion of the top bureaucracy" (p. 1694).

5/ To fill the void in the incentive structure of workers and managers created by the absence of "the stick," SEs resort to use of "the carrot"--they stimulate worker participation in profit-sharing and decision-making. These attempts have not been too successful--see below.

6/ Using a static framework, my estimate of the deadweight losses attributable to the moral hazard created by compensatory redistribution and ineffective external control of Yugoslav firms is 6-7 percent of GNP (Vodopivec 1990a).

is a constant danger that subsidies are only partly financed by fiscal revenues and that the state will resort to expansionary monetary policy (which has happened on a large scale in many SEs). Under CPEs, macroeconomic imbalance took the form mainly of shortages of consumer goods and hence of repressed inflation. With reliance on the market (using prices as signaling devices), macroeconomic imbalance in reforming SEs (those that have abandoned central planning as key allocator of resources) also takes the form of open inflation as well as external imbalance. This is even more of a danger as tax/subsidy schemes grow more sophisticated.[7] And the burden of such compensatory redistribution frustrates attempts to stabilize the economy through restrictive monetary policy or by reducing the public sector deficit.

Distributive inefficiency. The bargaining process through which income is redistributed in SEs affects the distributive efficiency of socialist economies. Not only are the privileges and perquisites of the elite at stake. If a huge portion of GNP is redistributed through informal bargaining, the system is bound to generate inefficiencies in both production and distribution--because organizational power differs among groups, as the logic of collective action implies (Olson 1965).

Current reforms

Until the 1980s, the growth record of socialist countries was reasonably good, although it relied heavily on the growth of inputs and was marked by microeconomic inefficiencies (the so-called extensive growth pattern). But growth slowed down markedly in the 1980s; extensive growth had hit its limits.

7/ One sophisticated way Yugoslav enterprises have been subsidized has been through release of the foreign exchange risk connected with those enterprises' foreign loans. That kind of subsidy is not transparent so authorities do not recognize its inflationary impact right away.

Moreover, Yugoslavia and Hungary, which had taken economic reforms the furthest, and Poland began experiencing serious external imbalances (mounting foreign debts), as well as internal ones. Yugoslavia and Poland suffered the kind of hyperinflation experienced in recent history only in Latin America.

Traditionally, reform in the SEs has aimed to improve rather than change the basic socialist system. But regimes' ability to preserve the basic SE model was severely weakened by rapidly deteriorating economic performance in the 1980s--and under a reform-minded new leader the Soviet Union actually stimulated reform in other SEs. So the late 1980s witnessed increasingly more radical reform in some SEs, which gradually transcended their traditional palliative nature, trying to transform the socialist economies into full-fledged market economies. This process culminated in (1) legislation that allowed decisionmaking rights on the basis of equity-capital, laying the legal foundation for the transition from socialism to capitalism (in Poland, Hungary, and Yugoslavia), and (2) the end of the Communist Party's political monopoly and legalization of the multiparty system. With the peaceful revolutions of 1989, the political and economic reform spread rapidly to the rest of the East European countries.

In recent years, the economic programs of the most eager reformers have been remarkably similar, although Yugoslavia--paralyzed by the recent escalation of ethnic strife--is now lagging behind Hungary and Poland in boldness of reform. Persuaded that the closely intertwined transitional measures should aim at both stabilization and long-term economic restructuring, these countries adopted broad economic programs that have triggered deep, systemic changes of historical importance. Among short-term policies, they have liberalized many prices (including exchange and interest rates) and foreign trade, and have adopted measures to contain inflation (tight control of wages and deep cuts in enterprise subsidies). Long-term, systemic changes required, above all, legislation (such as Hungary's Law on Transformation) that allows social/state property to become clearly owned commercial corporations, thus providing the framework for p_ivatization. Other important changes include significantly liberalized laws on foreign direct investment, revamping of the tax system, and changes in the financial system (the introduction of capital markets and, in Hungary and Poland, a two-tier banking system).

2. FEATURES OF THE LABOR MARKET

In Marxist ideology, the primary avowed goal of socialist countries has been to abolish the exploitation of workers supposedly found under capitalism. According to Marx, under capitalism, workers are treated as "commodities" and are exploited by selling their labor at a price below the value of what that labor produces. Marx claimed that workers are forced into such transactions because selling their labor is their only source of income, and the so-called industrial reserve army prevents wages from rising above subsistence. To uproot exploitation, then, abolition of the labor market is no less important than turning ownership of the means of production over to the public.

Socialist countries sought to deny the very existence of a labor market, both legally and theoretically. By emphasizing the right to work, by generating jobs for virtually everyone willing to work, and by effectively forbidding the firing of workers, SEs have tried to suppress not only the labor market, but also the treatment of labor as a commodity[8]--hence their reluctance even to talk about the demand for and supply of labor.

Yet it is fairly easy to identify a labor market in these economies. Institutions of that labor market are undoubtedly peculiar and function under many constraints but in socialist economies, too, labor is allocated mostly through the labor market. Decisions about the supply of labor in socialist economies are essentially voluntary:

(1) In socialist countries, the quit (voluntary separation) rate is normal --that is, comparable to the rate in developed market economies. The labor turnover rate in Poland in 1965-79, for example, stabilized at 20-21 percent, dropped to 15.7 percent in 1981 during a severe crisis, and rose back to 19.1 percent in 1986 (annual rates, Rocznik Statystyczny, various issues). Relatively few of the separations were dismissals--in 1975-80, only 4.6 to 7 percent of total separations (Simatupang 1983). Kornai (1986c) reports a quit rate of 15.7 percent in Hungary in 1982. In Yugoslavia, labor turnover tended to decline (probably in relation to rising unemployment) dropping from 20.3 percent in 1970 to 13 percent in 1987 (Statistical Yearbook of Yugoslavia,

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8/ A more serious attempt to address capitalist exploitation is self-management (as introduced in Yugoslavia), which allows for worker participation in decisionmaking and profit-sharing. To emphasize that it is the workers who receive surplus value, the personal earnings of Yugoslav workers are divided in two parts: a reward for "live" labor and a reward for the management of "past" labor (Marx's term), or capital. Without contractual determination of either part of personal earnings, however, the distinction--despite being implemented on a grand scale--is completely artificial.

various issues).[9] Dismissals were insignificant in both Hungary and Yugoslavia.

(2) Most SEs do not administratively assign labor in the sense of directing workers to specific jobs. The Soviet Union has been assigning graduates to specific jobs, and practicing organized and social recruitment, but that has affected only a small portion of the labor market.[10]

(3) Migration from one region to another, an important aspect of labor mobility--is influenced mainly by standard economic factors (Mitchneck 1990).

Thus, the labor market in socialist countries is roughly comparable in mobility with developed market economies. Moreover, a good deal of economic activity in SEs has been carried out in the "second" economy where market forces clearly do affect the allocation of labor. But that is not to deny the specific constraints on institutions supporting the labor market in the SEs, to which we now turn.

Systemic constraints on the labor market

Job security. Once employed, workers in SEs need not fear losing their jobs. They can be dismissed only for seriously breaching work discipline (with unexcused absences, for example, or drunkenness on the job).[11] And the dismissal procedure usually involves trade unions whose actions reflect the belief that dismissing malfeasants would only shift the burden of their

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9/ For comparison, in 1970-81, the quit rate in U.S. manufacturing ranged from 14.4 percent to 33.6 percent; in Sweden, from 15 percent to 25 percent; in Japan, from 9.1 percent to 15 percent; and in Italy, from 6.5 to 13.7 percent (OECD 1986). Labor turnover in manufacturing is usually higher than in the rest of the economy.

10/ Granick (1987) uses the quit rate and administrative assignment of workers to jobs as criteria for the existence of a labor market.

11/ For details on Yugoslavia, see Prasnikar and Svejnar (1988).

support onto the shoulders of others (an attitude shared by courts dealing with such labor disputes).[12]

The obligation to work in a social sector. The authorities in socialist countries have always preferred employment in the social sector to employment in the private sector. This goal was originally achieved by nationalizing most of the means of production, leaving limited scope for the private sector. All SEs have kept the private sector insignificant by legal limitations (especially on the size of private firms), discriminatory taxation, and limited access to and unfavorable terms for credit. The socialization of production extended even to agriculture--except in Poland and, after an unsuccessful collectivization attempt, Yugoslavia. Sentiment against socialized production was stronger in agriculture than in any other sector.

Fringe benefits. Workers in socialist enterprises enjoy substantial fringe benefits in the form of basic social services for themselves and their families (such as health care, education, child care, generous maternity and sick leave, subsidized housing and vacation, and pensions). Providing such basic social services to everyone is appropriate under socialism. Marx, in his famous "Critique of the Ghota Program," said that the communist ideal of distribution (from each according to his ability, to each according to his needs) was not feasible under socialism, but he insisted that a socialist society should provide basic services for every individual. So many labor-related costs are payments for social services. Some of the fringe benefits (such as health insurance) tend to decrease differences in personal earnings,

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12/ The ILO (1984) says there are few disputes about dismissals because they are so rare.

but others (such as housing subsidies) tend to increase differences (see Central Statistical Office of Hungary and others, 1989).

Regulation of work time. Working hours are rigidly set in socialist economies. This rigidity appears to be used to fight the illegal and semilegal activities of the second economy, and reflects the official position that work is a "sacred duty of all members of socialist society." In other words, not only is everyone supposed to work,[13] but employment is virtually exclusively full-time. Part-time work, reserved mainly for retirees and people taking second jobs, is of only marginal importance. Moskoff (1984), for example, reports only a minuscule proportion (0.32 percent) of part-time workers in the Soviet Union in 1979. The labor market in SEs is thus a classic example of a quantity-rationed market (see Killingsworth 1983), forcing individuals to make take-it-or-leave-it choices and thus suboptimal decisions.

Direct employment controls. Job assignments are not used significantly to allocate work, but most SEs have at least temporarily relied on setting employment limits on certain enterprises and industries. Hungary, for example, imposed a selective control on employment between 1976 and 1981, classifying enterprises by employment regimes. Some enterprises could increase employment but others were forced to keep employment unchanged, or reduce it--or even to assign workers to priority enterprises (Fazekas and Kollo 1985). Similarly, in the 1970s, Polish and Czech enterprises operated under employment limits (Adam 1984). Even Yugoslavia occasionally resorted to

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13/ There is a strong stigma attached to unemployment. Although the pressure to take full-time work is mostly informal, the so-called anti-parasite laws at times call for administrative sentencing of employed people to compulsory work.

freezing employment in the nonproductive sector (social services and the government bureaucracy).

Wage regulation

One of the most difficult tasks a government can undertake is wage control. The authorities in socialist countries have no choice. Imperfect by nature, the labor market in SEs also suffers from the requirement that the socialist state participate in the distribution of a firm's income simply to prevent the erosion of capital--for example, by prescribing the rate of return on capital[14] or by wage regulation. Not surprisingly, SE governments have continually engaged in wage regulation.

A standard component of early reform efforts aimed at boosting productivity was to replace the traditional, direct methods of wage regulation with indirect methods (in Yugoslavia in the 1950s, in Hungary in 1968, and in Poland in 1973). Direct methods involved assigning a wage bill that depended on the fulfillment of output targets. Such a method of wage control allowed authorities to control the level of the wage bill, an ability they lost when changing to indirect wage regulation. Indirect methods still relied on countrywide determination of the basic wage rate (by skill exertion matrices) but use value measures (such as value added or gross output) to calculate an enterprise's performance index. This index is then used to determine the "socially appropriate" level of the wage bill following meticulous--if ad hoc--rules on how to calculate the wage bill or the profit-sharing component of wages.

14/ This role of the state is caused by the absence of explicit, transparent, and easily transferable property rights--see Furubotn and Pejovich (1970).

The schemes used for wage regulation have usually been complex, prescribing in detail a method for calculating the approved level of wages. Moreover, different modes of regulation are used for different types of enterprises. In Hungary, for instance, the schemes allow for automatic yearly increases in the wage bill, regardless of performance, as well as for average "wage brakes" (in the form of the percentage increase in the wage bill)--above which the enterprises face high marginal tax rates. Moreover, other criteria besides the performance index are used. To discourage employment, for example, Polish enterprises were directly taxed on new employment (Adam 1982). Hungarian enterprises were granted a special tax-free allowance for cuts in employment. In Yugoslavia (Vodopivec 1989) and Hungary, increases in the wage bill were granted for expanding exports to hard-currency countries.

What is striking is the narrow range of wage differentials among enterprises. A highly progressive tax actually prohibits any wage increases above a certain low threshold (historically 6 percent a year for Hungary), and "needy" enterprises are generously subsidized.[15] As a consequence, the profit-sharing part of wages has been kept low--in Hungary, to about 4 percent in the early 1980s (ILO 1984).

Rules on distribution of a firm's wage bill among the workers is one important element of wage regulation. Drawing again from the writings of Marx, SEs have allegedly pursued the principle "to everyone according to his work" by using the so-called tariff system. Under the tariff system, jobs are

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15/ Thus, Kornai and Matits (1987) find a weak correlation between the after-tax subsidy which affects wage formation and the original profitability of Hungarian enterprises. Cukor and Kertesi (1987) find a direct link between redistribution and wages. For Polish loss-makers, Schaffer (1990a) finds that an increase in presubsidy losses is nearly and predictably matched by an increase in subsidies.

classified (based on such factors as required education, physical strain, and working conditions) into different skill grades--the "skill-exertion matrices --to which economywide wage rates are centrally assigned. To stimulate productivity, various bonus schemes are superimposed on base wages, tying rewards either to individual productivity (piece rates) or to collective productivity (profit-sharing schemes).

Yugoslavia, which deviated from Soviet wage regulation in the 1950s, was not only the first but has possibly gone the furthest in the originality and sophistication of its wage regulation. Unlike other socialist countries, Yugoslavia has used skill-exertion matrices only to determine relative proportions of personal earnings, not the base level of wages. And in its "income accounting system"--under which no labor payments are treated as costs (thus avoiding the notion of profits)--the entire wage bill, at least in principle, is left completely undetermined in advance (except for minimum wage provisions).

Another refinement of the Yugoslav system is that the individual performance index is assessed on the basis of the performance not only of that enterprise but of the industry and economy as a whole.[16] Typically, the socially appropriate wage bill is calculated by applying the corrected performance index of the enterprise to the exogenously given norms for personal earnings. The performance index is corrected to reduce wage differentials among enterprises. On one hand, workers in successful enterprises are allowed to earn above-average wages, but are subjected to progressive taxation. On the other hand, although workers in below-average enterprises earn below-average wages, they are effectively subsidized

16/ See Schrenk (1981) or, for more recent regulation, Vodopivec (1989).

(Vodopivec 1990a). So even though the procedures for regulating Yugoslav wages differ substantially from those used in the rest of Eastern Europe, regulation still tends to level differences in personal earnings among enterprises as it does in other socialist countries.[17]

Not only do SEs regulate wages but those wage regulations typically change constantly. The history of regulation is the history of a continual search for a "perfect" system. Virtually every year, for example, Hungary revises the rules about granting tax-free wage increases as well as the tax rates on profits. What is more, these changes are sometimes small modifications and sometimes substantial shifts in principle. Hungary, for instance, after relying mostly on wage bill regulation since 1968, reverted to the predominantly average-wage-level regulation between 1983 and 1988, only to shift back (in a recent overhaul of the wage system) to wage bill regulation. In 1983, Poland also reverted from average-wage-level to wage bill regulation.

Typical of wage regulation under the SEs has been the widespread, after-the-fact granting of concessions and exemptions from taxes. Enterprises' revenues often simply cannot support the "socially appropriate" level of wages and also cover their obligations--indeed, revenues often cannot cover even the wages. The tax-subsidy system that is integral to wage regulation is already highly selective and progressive, but additional concessions and exemptions are often granted to the least profitable enterprises to prevent socially disruptive strikes. This is particularly true in Poland, where arbitrary relief has been a common practice despite relaxation of the rules to prevent such ad hoc intervention.

17/ Vodopivec (1990a) confirms that the control of income distribution in Yugoslav firms has been effectively enforced, with the leveling of income among firms as its primary motive.

Such constant changing of the wage regulation rules is a clear indication that without theoretical guidance, authorities resort to pragmatism. In 1983, for example, Hungary switched performance indicators, using the ratio of profits to the sum of the value of fixed assets and the wage bill as an indicator instead of the growth of value added, which had been used previously. This choice cannot be defended on theoretical grounds. True, the value-added criterion discriminates against firms with a high starting base (that is, against firms that have already increased productivity and may not have room for more efficiency improvement), which is but another form of the "ratchet" problem (the official rationale for its abandonment). But the new measure is not free of shortcomings. First, profits may not be a legitimate financial indicator in a system with distorted relative prices, an oligopolistic market structure, and a whimsical tax and subsidy system (the value-added performance indicator fares better on this count). Second, the denominator of the measure (the sum of the value of fixed assets and the wage bill) is obviously determined on an ad hoc basis, being the sum of the stock and the flow.

3. HOW THE LABOR MARKET FUNCTIONS

Given these systemic features in the SE labor market, how does that labor market function? Typically it is characterized by overemployment, which manifests itself in the suppression of work incentives, inefficient allocation of labor, and wage drift, all of which are discussed below.

The full employment syndrome

Historically, the SE labor market has been characterized by overemployment. On the one hand, firms use workers inefficiently. Given the technology and capital stock available, they maintained too many often overqualified workers (unemployment-on-the-job, or disguised unemployment). On the other hand, widespread labor shortages are common, generally for particular skills. In fact, disguised unemployment and labor shortages have occurred simultaneously nationally and in individual enterprises: labor shortages prevent firms from hiring workers they need, yet some workers on the payroll are underemployed.

In different economic systems, the phenomenon of full employment (and relatedly, the natural rate of unemployment) differs profoundly. The balance of supply and demand implied in the term "full employment" is not as important as different adjustment mechanisms used to achieve it. Market economies arrive at full employment through flexible market adjustments. SEs arrive through rigidities that limit the options available to firms and workers and through pervasive ad hoc government interference in firms' decisionmaking. This rigidity and interference affect the environment that firms and workers experience and change their behavior. So full employment in SEs differs vastly from market economies. In particular, the demand for labor in market economies is derived demand, which reflects changing conditions in the product markets. The demand for labor in SEs, because of subsidies, is essentially autonomous--instead of relying on increased aggregate demand to generate full employment (as Keynes prescribed), governments in SEs subsidize factor demands.

Historically, SEs have achieved full employment through deliberate policies of intense investment coupled with labor-intensive techniques and low real wages. This has generated massive new employment, siphoning excess labor from agriculture and increasing the participation of women in the labor force. With the labor reserves fully exploited, the economies experience both chronic labor shortages and substantial disguised unemployment.[18] Yugoslavia, which had an unemployment rate of 15 percent by the end of the 1980s, was a significant exception. But open unemployment did not change the way the labor market functioned, so the same negative consequences that could be found in the other socialist economies apply to Yugoslavia as well.

SEs have maintained full employment by subsidizing employment. This has been accomplished (1) by keeping wage differentials low, effectively forcing productive workers to subsidize less productive workers, and (2) through state paternalism, by softening budget constraints faced by firms and thus fueling firms' quasi-insatiable demand for labor (and other inputs).

At the heart of full employment in SEs is the lack of appropriate mechanisms to enforce the exit of firms (workers) that fail to behave according to the standards set by the society. Managers and workers expect job security and (even ever increasing real wages), whatever their performance as reflected in the firm's financial results. In the CPE model, as Granick (1987) documents, this expectation is fulfilled by explicit planning for full employment. Job/wage expectations do carry over to reforming SEs, but in

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18/ Adam (1984, 36) estimates the underuse of work time (a proxy for disguised unemployment) as 10 to 30 percent in Hungary, and 8 to 10 percent for Polish manufacturing, and 20 to 30 percent for Polish services. Mencinger (1989) estimates that approximately 20 percent of employment is redundant in Yugoslavia. (Different methods are used to measure labor redundancy, so the estimates are not comparable.)

those economies the mechanism through which these expectations are fulfilled is different. Rather than being achieved by planning, job/wage security is produced mainly through a complicated bargaining process (which could be considered as bargaining for employment subsidies). The outcome of bargaining is a massive redistribution of income, which amounts to bailing out (preventing bankruptcy or layoffs) and increasing the earnings of ailing or less productive firms and workers--all at the expense of the more productive firms or workers or of the household sector. In other words, the notorious softness of firms' budget constraints--the consequence of state paternalism--explains job/wage security in the reforming SEs.[19]

Kornai (1986b and elsewhere) has discussed the mechanisms through which state paternalism is implemented in SEs--including the manipulation of prices, taxes, and subsidies as well as concessionary finance. And both the introduction of commercial banks--which are also socially owned in SEs--and especially decentralization of the economy exacerbates the problems of the softness of the budget constraint. So if anything, decentralization of the SEs diminishes the authorities' ability to control the financial system.

Such redistribution is significant, according to the few studies that have been done on this subject--Kornai and Matits (1987) for Hungary, Saldanha (1990) and Schaffer (1990a and 1990b) for Poland, and Vodopivec (1989) for Yugoslavia. For example, Schaffer (1990b) reports that direct subsidies to Polish enterprises amounted to 14 percent of GDP in 1989, to which one should add implicit enterprises subsidies through concessionary financing (which exceeded 10 percent of GDP, according to Saldanha). Moreover, the forms

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19/ For an explanation of the persistence of job security in reforming SEs as a predictable outcome of bargaining among distributional coalitions, see Vodopivec, 1990c.

through which redistribution is implemented vary from country to country, but its pattern remains remarkably unchanged. As Kornai and Matits put it (p. 30): "[the authorities] take a lot away from units that have a lot; those that have little can in all likelihood count on being compensated for this."

Massive redistribution through state paternalism is usually attributed to the socialist quest for equity (this is also the position Kornai takes). But specific vehicles used for redistribution make it doubtful that noble egalitarian feelings fully explain this phenomenon. After all, state paternalism is an ineffective vehicle for reducing inequalities, [20] so why not use other methods? One could argue that compensatory redistribution persists because political elites (bureaucrats and managers) want to maintain the status quo--including their privileged positions--by avoiding such social disruptions as strikes.

Many consider the socialist economies' achievement of full employment a remarkable success.[21] Socialist economies seem to avoid the waste of human resources produced by both the nonutilization of the part of the labor force involuntarily unemployed, and the dissipation of human capital caused by lasting unemployment. Giving work to everyone who wants to work also has great social appeal because it prevents such psychological damage as the insecurity (especially harmful to youth)[22] and the loss of self-respect

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20/ SEs have themselves realized this increasingly. For example, Gierek's agenda was to substitute "rational employment" for "full employment" policies. Moreover, the SEs have been tinkering with the concept of bankruptcies for a long time.

21/ Kornai, for example, argues that the "elimination of unemployment is an achievement of great historical importance" (1986a, 131).

22/ Ehrenberg and Smith (1982) present some evident on the long-run harm of teenage unemployment.

experienced by people who want to work but cannot. Moreover, Gabor and Galasi (1985) argue that government subsidy overcomes an externality imposed on society by individual firms that, in their employment decisions, do not take into account the costs of unemployment benefits.

The suppression of work incentives

On the microeconomic level, the full-employment syndrome manifests itself in the suppression of work incentives.

To understand why work incentives are so important in an analysis of the productivity of socialist firms and workers, let me summarize a theory about the firm that is particularly appropriate for such an environment. One important characteristic of the firm is the informal, nonspecific nature of its internal contracts (FitzRoy and Mueller 1984).[23] When the environment is not competitive (and in the short run, even when it is) the firm's members have room for discretionary behavior. One can thus treat services of workers as comprising two parts: a contractual part, seen as fixed and determined by the prevailing norms (which can be set very low in SEs), and a noncontractual part, which the workers provide in response to incentives institutionalized in the firm's "economic design." A firm's efficiency depends on incentives to elicit noncontractual contributions of effort and information (Mueller 1976).

Here the concept of the carrot and the stick is useful. Capitalist firms traditionally rely on the stick (as specialized monitoring) to motivate work. This kind of motivation has been eliminated from the design of the

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23/ This contrasts sharply with the orthodox neoclassical economics, which views the firm as being characterized by (a) a technological transformation (production) function, and (b) objective function. Contractual arrangements constituting a firm, and other institutions typically found in firms are neglected on the ground that they function sufficiently costlessly and flawlessly (Winter 1988).

socialist system. Firms don't have it because there are no external disciplinary devices (or those that exist are lax) and individuals don't have it because they have a "permanent right" to their present job.

Without a stick, SEs must rely for incentives on the carrot--for example, worker participation in profit-sharing or decisionmaking. There is no general theory on the comparative effectiveness of carrot and stick incentives, so it is difficult to judge whether the socialists' exclusive reliance on the carrot incentive is necessarily less effective than the capitalist firms' predominant use of the stick. The empirical literature on Western economies finds that worker participation increases workers' motivation and thus productivity,[24] but these are results from an environment in which worker participation is superimposed on--not replacing--the stick incentives. Insights from game theory on the equilibrium of "profit-sharing supergames" is also inconclusive. Game theory allows for a cooperative solution of a prisoners' dilemma type of problem in profit-sharing firms, making profit-sharing superior to fixed wages. But in less favorable circumstances, profit-sharing may also generate noncooperative equilibria, inferior to fixed-wage equilibria (see Weitzman and Kruse 1990). It is hard to predict which outcome will prevail.

Socialist firms--completely dependent on carrot incentives and severely constrained in their use--have failed to institute adequate work incentives for several reasons:

(1) Historically, profit-sharing and bonus schemes have proved ineffective. First, interfirm redistribution (the heavy taxation of profitable firms and the subsidization of workers in financially weak firms) has severely dampened

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24/ See Blinder (1990) for a recent review of the literature.

the incentive effect of profit-sharing. Second, distorted relative prices and bureaucratic price regulation separated a firm's financial results and performance, decreasing the importance of improving productivity to increase firm revenue. Third, bonus schemes suffer from such shortcomings as the failure to subject all firms to the same incentives, the differential treatment of material and labor inputs, and the complex, theoretically weak basis for wage regulation (necessitated by second-best considerations). Fourth, without the threat of dismissal, profit-sharing is weakened as a motivational device. The inability to exclude workers may prevent the homogeneity needed for social enforcement mechanisms such as peer pressure to be effective.

(2) Egalitarianism through interfirm redistribution is reinforced through centrally imposed skill-exertion matrices (which largely determine the relative earnings of individual workers in a firm). This produces a more compressed wage structure than in capitalist countries.

(3) Ideological criteria dominate in hiring, and internal labor markets are ineffective. Simatupang (1982) describes the frustration and discontent of highly qualified (particularly young) employees because of the incongruity between their professional aspirations and the limited possibilities for fulfilling them.

Inefficient allocation of labor

Another manifestation of the full-employment syndrome is the inefficient allocation of labor. Simatupang (1982) reports that, because of enterprises' hoarding tendencies, the proportion of employees with higher technical education in the nonagricultural sector is much higher in Poland (1.96 percent) than in many Western countries (ranging from 0.71 percent in France to 0.40 percent in West Germany). Moreover, to increase wages under particular wage regulation schemes, enterprises tend to hire workers whose base wages are below the firm average (Marrese 1981) or (in Poland) relatively unskilled workers.

In general, in so constrained a labor market, labor mobility, although voluntary, may not improve the efficiency of labor allocation. Employment subsidies create a wedge between the wage paid to workers and their value marginal product. The wage does not reflect the opportunity costs of labor so it does not send the right signals for labor allocation economywide. If value marginal product in firm A does not equal value marginal product in firm B, welfare could be increased by reallocating labor from the less productive to the more productive use. But if both firms pay the same wage rate, workers themselves have no incentive to change employers and the evidence shows that alternative allocative mechanisms, such as direct administrative measures, are ineffective.

The authorities in socialist countries often complain about excessive labor turnover, which allegedly interrupt production, add to the costs of recruiting, training, and so forth. (Various economic and administrative measures taken to reduce turnover have apparently failed.) Viewed from the commanding heights of the economy, no doubt it is hard to understand workers' job changes even if they increase productivity. And the discontent of the authorities with high turnover may be economically justified: since wages in SEs do not reflect the relative scarcity of different types of labor, labor turnover might indeed bring about only individual gains (through redistribution), with no social gain.

One of the most drastic consequences of job security is the "perverse" allocation of resources--comprising both the cost of inputs and the opportunity cost of factors of production--the cost of maintaining inefficient production. Such costs can be much higher than the mere cost of subsidizing employment.

The tendency toward wage drift

Socialist economies currently lack an impersonal mechanism to countervail the tendency toward wage increases. If the distribution of income in the firms were left uncontrolled by higher authorities, the resulting wage drift would probably lead to two types of macroeconomic unbalance. First, the economy's savings rate would drop (since at present there are few opportunities for individuals to invest productively). Second, because of accommodating monetary policy and firms' ability to resort to money substitutes (increasing the velocity of money), an excess aggregate demand would emerge, producing open or repressed inflation (depending on the price regime).

One can argue that the ill-defined structure of the property rights underlies macroeconomic imbalances in SEs. For one thing, capital assets in SEs are state owned. This means that investments the firm makes from its own resources are nonrecoverable, so workers have no claims--individually or collectively--to the firm's business fund when they separate from the firm. That results in the well-known "horizon problem" described in the literature on self-management (see Furobotn and Pejovich 1970, or Jensen and Meckling 1979): unable to recover their original investment the workers choose to work with relatively little capital. (In reality socialist firms mostly get external financing for their investments, so there is no evidence of a horizon problem.)

The discretionary nature of property rights in SEs (another facet of state paternalism) also contributes to the phenomenon of wage drift. Under the prevailing structure of political power in SEs, the state can redistribute significant portions of GNP through (1) ad hoc interventions (taxation or subsidization) into the distribution of income at the firm level, and (2) (mis)use of the financial system. Unprofitable firms get subsidies (such as straight subsidies, concessionary crediting, and tax waivers) that are in turn converted into components of demand. But this massive redistribution of income is usually only partly financed by fiscal revenues. Yugoslavia and, more recently, Hungary and Poland, rely heavily on monetary expansion to finance state interventions--with unavoidable inflationary implications.

Some believe that fiscal imbalances cannot account for Yugoslavia's notorious macroeconomic instability, because Yugoslavia always has a balanced budget. Rocha (1990) argues that the impression of a balanced public sector budget is false--that there is a hidden but real deficit of significant proportions. This deficit consists mainly of implicit subsidies to enterprises (1) by providing domestic credits at highly negative real interest rates, and (2) through a foreign exchange insurance scheme that allows enterprises that take out foreign loans to shift the repayment of their debt onto the shoulders of commercial banks or the central bank, financed by the inflation tax. (See also Bole and Gaspari 1989.)

Bole and Gaspari (1989) show that other factors also contribute to inflation in Yugoslavia--especially the inconsistent, often changing economic policy itself. Sporadic price controls in particular have blocked relative price adjustments, so that exchange-rate adjustments have influenced only the general prices without affecting the structure of production. Their very repetitiousness shows the ineffectiveness of price controls, escalates targeted price increases when the price freeze is lifted, and thus increases inflationary expectations. Furthermore, Bole and Gaspari find that wage and monetary policy, and the introduction of the new accounting principles in 1987, generate significant inflation--the latter by increasing the economy's "degree of indexation."

Another factor helps explain the recent escalation of inflation in Poland, Hungary, and Yugoslavia: the external imbalance that necessitates an exchange-rate adjustment. When workers can fight price increases by raising their wages, one mechanism to reduce wages (the so-called Pazos-Simonsen mechanism) is to permanently increase the rate of inflation. This points to the presence of the other, traditionally recognized character of inflation in socialist countries: cost-push inflation. But it is important to realize that inflation in SEs has not been fueled only by mounting costs--that is, has not been only a cost-push character. So long as these economies do not address the fundamental imbalances associated with the subsidization of enterprises (particularly nonviable ones), there is no chance for permanent stabilization.

Interaction between the first and second economies

Because of restrictions on ownership and the labor market, a "second economy" has emerged in SEs. This economic sector is usually defined as comprising all activities that are not performed in the state/social sector--not just the illegal activities that comprise the "underground" sector of market economies.

The second economy includes both formal and informal activities. Among formal ones (officially licensed to conduct business and therefore liable to taxes), the most important are crafts, retail trade, residential construction, and catering (for such countries as Hungary, Poland, and Yugoslavia). The business is usually performed by the owner alone, sometimes with the help of family members or a few hired employees (in Yugoslavia, only half the owners employ one hired employee, on average).

The informal part of the second economy consists of (1) legal economic activities that do not require incorporation; (2) legal economic activities performed in a way that violates laws or regulations (for example, running the business without a license to avoid paying taxes, or performing a second-economy activity during regular working hours or on sick leave, or with material and equipment stolen from the first economy); and (3) unlawful activities. Important activities include household farming and residential housing, repair, and maintenance.

Most activities in the second economy are probably carried out in the informal private sector. For Hungary in 1984, Kornai (1986a) estimates that about one-third of working hours are spent in the second economy, and that the informal private sector might add 20 percent or more to official GDP. For Yugoslavia, Kukar (1988) finds the scale of second economy activities increasing steadily from the 1960s on, amounting to between 16 and 25 percent of GNP in 1981.

The second economy is, in many ways, a rational response to the constraints imposed on economic activities in the "socialist" sector. Several factors encourage participation in the second economy: the possibility of avoiding taxes, the internalization of the externalities connected with providing effort, the narrow range of officially sanctioned wage differentials, and often the dictation of high prices by an inefficient and unresponsive social sector. And several factors discourage participation in the second economy: the stability of income, relat'vely low level of effort, and significant fringe benefits attached to employment in the social sector. (Many fringe benefits, such as health insurance, cover family members, so at least one family member usually holds a "first economy" job.)

A curious symbiosis develops between firm management and dual-status workers (those participating in both economies). The firm tolerates below-average efforts by dual workers yet benefits from employing such workers because their dismissal would only aggravate the shortage of labor (Kertesi and Sziraczki 1985).

The existence of the second economy allows workers to work beyond the rigidly set work hours of the first economy. Moreover, the laxity of work discipline helps reduce the hours worked ("stolen hours"). Gaddy (1990) argues persuasively that the distribution of labor supply resembles that found in the market economy.

4. POLICY IMPLICATIONS AND RESEARCH ISSUES

The foregoing description of the features and functioning of the labor market in East European countries is a useful starting point for talking about the design of labor market policies during the transition to a market economy --particularly since labor market adjusts notoriously slowly, and will probably persist in old patterns for some time. Like most economists analyzing this economic transition--a transition of unprecedented magnitude--I hesitate to offer detailed prescriptions and solutions for economic policy.

Rather, I identify crucial labor market policy issues, draw some tentative conclusions, discuss questions policymakers must face during the transition, and identify important research issues.

Mobility and absorption of labor

A key feature of the transition will be redundant labor and, almost certainly, unemployment of significant proportions together with labor shortages for certain skills. A major challenge for these economies will be to achieve a massive reallocation of labor (among firms, industries, occupations, and even regions) at the least social cost. What that cost will be depends on the success of the reform generally and the appropriateness of the labor market and social protection policies in particular.

"Active" labor market policies will be particularly important during the transition. Unemployment benefit schemes are designed primarily to provide income support to unemployed workers, so they only alleviate the painfulness of involuntary unemployment. Market economies in the developed countries have come to recognize that income support schemes are ineffective at reducing unemployment. Active labor market policies are needed--those that enhance labor mobility and increase labor absorption, thus helping to reintegrate unemployed workers into the labor market. To achieve this, SEs must significantly improve and expand their facilities for training and retraining workers, and employ other, more heterodox labor market policies (such as assisting small businesses, improving the educational system, linking universities with businesses, and helping with technology transfer).

Appropriate income support policies must complement active labor market policies. Most SEs have overgenerous income support programs. Under certain circumstances, Yugoslav workers are guaranteed income for 24 months after being laid off (Crosslin 1990). And Yugoslav legislation distinguishes between "economically" and technologically" redundant workers (with significant implications for income support), a distinction that is completely arbitrary and thus unwarranted.

The inefficient housing market in SEs significantly deters labor mobility. Compared with the rate of housing turnover in market economies (15 to 20 percent) the rate of housing turnover in SEs (1 percent in Poland, for example) is inefficiently low (Renaud 1990). Historically, housing has a low priority in government investments so there is a huge shortage of dwellings. (In major Polish cities, for example, there are waiting lists for housing of 15 or more years.) Among other things, the housing shortage is caused by high construction costs (which contribute to the extremely high ratio between the price of housing and personal earnings), and artificially low rents for state-owned apartments. The latter contributes to the inefficient use of dwellings and tends to reduce the housing supply by encouraging inadequate maintenance--typically, rent revenues cover only about 25 to 50 percent of maintenance costs! The more important type of housing subsidy has been concessionary credits for the purchase of apartments or building materials.

Housing reform should be oriented in the following way: Socially owned apartments should be privatized, and owners' rights should be respected no less than tenants' rights. This would mobilize and channel savings into residential construction, and provide incentives for the maintenance of existing housing stock. At the same time, the financial system should be reformed: rents on socially owned apartments should be increased and, in general, the regressive subsidization of housing should end, to be replaced by housing allowances for targeted groups (young or poor families). On the supply side, measures should be taken to reduce the high production costs of housing--for example, by fostering competition among construction companies, restructuring urban planning, and facilitating access to land sites.

Wage and employment policies

The crucial question about the full employment syndrome is whether the SEs can impose and sustain financial discipline in the long run (applying strict economic criteria in financial intermediation--in particular, cutting financial aid to ailing firms). In other words, can they eliminate (employment) subsidies?[25] I have argued that job security and the resulting redundant employment have not been so much an official goal of the reforming SEs, as they have been a way to preserve the status quo (and hence the privileged position of bureaucrats and managers). To impose and sustain financial discipline (the "hard budget constraint") is, therefore, not only a matter of top government officials being willing to impose it--if the system remains unchanged. Rather, the conditions for imposing lasting financial discipline are much more demanding, and include: transparent (individual) property rights, an unselective and transparent fiscal system, and a multiparty political system (to provide checks and balances for the ruling party and thus contain its ability to redistribute--see Vodopivec (1990c).[26]

Add this important caveat: it is crucially important to end the full-employment syndrome, but shock therapy in the form of cutting all enterprise

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25/ With the recent substantial reduction of price controls, a significant source of redistribution (one that is difficult to measure) has been to a large extent eliminated.

26/ To achieve financial discipline in the short run, these conditions may be replaced/complemented, to some extent, by government commitment to stop subsidies, backed by the support of international agencies (IMF, World Bank) and accompanied by an appropriate safety net to cope with the resulting unemployment.

subsidies overnight is hardly advisable. In an economy where so many parameters deviate from their likely long-term values, many potentially viable producers could be hurt as well. It is much more desirable to gradually phase subsidies out--perhaps over two to four years, as proposed by Svejnar (1990). Alternatively, Murrell (1990) advocates gradual transition through the so-called dual economy.

The area of industrial relations is also extremely important. The SEs' hasty reversion from socialist goals and principles to those of capitalist, market-oriented economies leaves unanswered many questions not only about the transition period but also about the much less ambiguously defined goal of transition (full-fledged capitalism). An important but unsatisfactorily explored issue is worker participation (encompassing decisionmaking, profit-sharing, and ownership). For instance, the evidence shows that a conventional wage system, in which wages (a salary) are unrelated to performance, is inefficient--that is, that workers in firms that allow for profit-sharing and possibly other forms of worker participation are more productive (Blinder 1990). Not surprisingly, Blinder (p. 2) argues that "a society starting over again to design a pay system to encourage high productivity would be most unlikely to choose the conventional wage system," a remark that undoubtedly applies fully to the postsocialist economies.

Economic reasons apart, worker participation is likely to be a feature of SE reform for political reasons. Workers who have already been granted the right to participate in ownership and control of a firm in the past, if only on paper, will probably want to retain those rights in the future (hence workers' resentment of privatization).

A related problem is job security. Recent research indicates that there need not necessarily be a tradeoff between the efficiency of adjustment and job security. Using measures other than layoffs, German firms have succeeded, over 12 to 18 months, in adjusting their employment as much as, and sometimes more than, U.S. firms (Abraham and Houseman 1988). There are also arguments for a corporatist wage bargaining structure (the Austrian or Swedish models, say). OECD (1987), for example, reports that "(t)he countries with encompassing bargaining structures have enjoyed better-than-average records of unemployment over the 1970s and first half of the eighties."

Incomes policies are also important, at least during the transition. Such policies could introduce centralized control through the back door, but it seems safe to assume that--at least in the near future and for sectors unaffected by changes in ownership--some kind of wage regulation will be needed. Given the unfavorable record of past wage regulation, however, many questions remain unresolved: which authority should be responsible for formulating and enforcing wage regulation? What kinds of control damage individual productivity least? Can wage regulation prevent the differences in firms' financial performance that arise from differences in market power and distorted prices? Should income policy be patterned after developed market economies and involve targeted economywide wage increases, or (probably more appropriately) should it allow enterprise-specific wage increases, taking into account the current situation, which is admittedly far from being a long-term equilibrium?

SEs should significantly change their current practices on nonwage labor costs and the taxation of wages. Currently, much of labor remuneration takes forms other than wages (not only health insurance and social security, but also the subsidy of housing and vacations, the provision of meals at work, and so forth). Similarly, heavy taxation of labor increases labor-related costs (typically, taxes and other nonwage labor costs constitute up to one-half of labor costs in SEs). Policy recommendations include: (1) shifting from nonwage to wage payments (among other things, this will enable firms to compete with the so-called second economy) and (2) overhauling the fiscal system, replacing the present system (direct taxation of the factors of production) with a personal income tax.

On the important issue of wage differentials, some (for example, Flakierski 1986) maintain that workers in socialist countries hold strong egalitarian sentiments that could render attempts to increase wage differentials (particularly within an enterprise) counterproductive. More plausible are arguments that egalitarianism is rooted mainly in opposition to the (semi)past practice of wage setting that completely blurs the link between individual performance and earnings (high earnings and perquisites are privileges reserved mostly for the ruling elite). The perception of inequality has been sharper because earnings differentials have been set by political authorities. As the institutional set-up changes, so will the limits on "socially unacceptable earnings differences," so a policy of widening earnings will become productive. Reform will also largely remove another reason wage differentials are vulnerable: the transparency of wage-setting.

Research issues

Finally, let me discuss some of the fruitful areas for research that the colossal "workshop" of today's Eastern Europe offers.

The reallocation of labor. The central and by far the most important area for research on labor in the East European transition is the reallocation of labor, which has already taken dramatic proportions (especially since these countries have a long history of full employment). Such research should try to answer some of the following questions: Which groups of workers are most at risk of becoming unemployed (for example, the elderly, disabled, or minorities? blue-collar or white-collar workers? men or women?)? Which groups of workers have the best chance for reemployment? How long does it take to reactivate? What is the long-term reemployment rate? What kinds of jobs do reentrants get? How helpful are the "active" policies to combat unemployment (such as retraining and assistance to small businesses)? Do reentrants move into different occupations, industries, or regions? What is the attitude of the family and neighbors toward the unemployed? Are there any signs that unemployment harms health? Research into these and related issues would provide many extremely relevant answers to policymakers.[27]

Subsidies. Given the central role subsidies have played in inflating the demand for labor in SEs, another important area of research is subsidies to firms during the transition period. This topic could be approached from several points of view: (1) the sustainability of cuts in subsidies in the context of the political economy of stabilization (see for example, Haggard 1985), (2) the impact of redistribution on macroeconomic imbalances, (3) the impact of income redistribution on the demand for labor and an assessment of the labor redundancies that result from such inflated demand, and (4) the

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27/ Ham and Svejnar (1990) is an excellent example of a research proposal along these lines, with detailed methodology. Regrettably, a World Bank (1990) project proposal on labor markets in Eastern Europe, by confining itself to existing data (p. 34) and focusing on macroeconomic issues (such as wage-price dynamics), ignores the big story: labor reallocation.

impact of income redistribution on work incentives (along the lines of Vodopivec 1989, for example).

As for the possibilities of subsidy, Hungary and Yugoslavia deserve particular attention because of their more developed system of commercial banks, and greater decentralization of political and economic decisionmaking. The development of other SEs will probably proceed in the same direction, so it is important to investigate the possibility that economic decentralization could actually worsen the economy's ability to return to a hard-budget constraint under conditions of (1) persisting state or social ownership and (2) a political system that lacks adequate checks and balances (a conclusion that the Yugoslav experience seems to support).

Worker participation. Research on the effects of worker participation would also be useful for policymakers. Studying groups of enterprises that differ about worker participation, it would be interesting to empirically investigate the effect of participation of workers in profit-sharing, decisionmaking, and ownership (along the lines of Estrin, Jones, and Svejnar 1987, for example), and to try to answer such questions as these: Which types of participation are most effective and suitable to the environment under investigation? Do they interact in any way, and how? What forms of participation in decisionmaking are most appropriate (workers' participation in the board of directors, as in German "codetermination," or more direct involvement, as in worker councils)? It would also be useful to help formulate government policy toward such participation schemes.

Failure of Yugoslavia's system. Finally, a study of the factors that have contributed to the apparent failure of Yugoslavia's system would be particularly useful. It might seem, for example, that the Yugoslav experience--produced by a system based, among other things, on worker profit-sharing and decision making[28]--contradicts the consensus in the empirical literature on worker participation in developed economies (summarized in Blinder 1990) that participation improves productivity. Another explanation for the Yugoslav failure, probably closer to the truth, is that forces similar to those in other SEs were at work, that had nothing to do with worker participation, but pushed the economy and society into the current crisis. These forces have not been identified or analyzed with enough professional vigor.[29]

28/ Hinds (1990) is one of the most vocal critics of worker participation, blaming it for the failure of the Yugoslav system.

29/ In this connection, it would be useful to investigate the economic consequences of the mid-1970s reform in Yugoslavia. Tyson (1979) and others have suggested that the introduction of Basic Organizations of Associated Labor in the mid-1970s, by decreasing the size of the firm, might have mitigated the "1/n problem" (the free-rider problem arising in team production when metering of labor inputs and/or output is imperfect/costly). Alternatively, the economic impact of the reforms might have been negative because the reforms may have pushed firms into excessive fragmentation.

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